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Internal Revenue Service
memorandum

CC:TL-N-9302-88
Brl:CEButterfield

date: NOV 14 1988

to: Regional Counsel, Southeast CC:SE
Attn: Special Trial Attorney, Atlanta

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is in response to your request for technical advice dated September 6, 1988.

ISSUES

1. Whether the safe harbor leases entered into by [redacted] for its interest in Plant [redacted] meet the minimum at risk requirements of former I.R.C. 168(f)(8). 0168-0000

2. Whether the language of the safe harbor leases identify the subject assets in sufficient detail to satisfy the identification requirements of the safe harbor lease provisions. 0168-0000

3. Whether two [redacted] lease properties qualify as transition property under section 208 of TEFRA and section 168(f)(8)(I) of the Code. 0168-0900

4. Whether financing provided to a Rural Electrification Administration (REA) cooperative by the Federal Financing Bank (FFB) under an REA loan guarantee constitutes "subsidised energy financing" within the meaning of section 48(1)(11) of the Code, as amended by section 223(C) of the Crude Oil Windfall Profit Tax Act of 1980. 0048-1500

5. Whether subsequent issuance of tax-exempt industrial development bonds (IDB) by [redacted] requires [redacted] and [redacted] to reduce energy tax credit by one-half as required by section 48(e)(ii). 0048-1100

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6. If it is determined that [redacted]'s issuance of the tax-exempt IDB's makes it necessary for [redacted] and [redacted] to reduce the claimed tax credit by one-half, are [redacted] and [redacted] required to reduce the credit on all of the qualified energy property, or only on the portion that was actually financed by the bonds. 0048-1100

7. Does the filing of a form 990, in good faith, qualify as a tax return for the purposes of electing an accounting period or method, depreciation lives and methods, section 266 capitalization treatment or any other election within the Code. 0446-0000

8. Would a taxpayer be allowed to change any of the elections indicated above merely by virtue of becoming a taxable entity without the consent of the Commissioner. 0446-0000

9. If [redacted], in good faith, filed a Form 990 but later determines that a taxable return was proper for the period, is [redacted] required to amend the filing by filing a taxable return.

10. Would the failure to file an amended return subject [redacted] to any penalties.

11. If [redacted] elected one method on its original Form 990 and in subsequent years elected another method without the consent of the Commissioner, both elections being made in years for which the statute is closed, which method should be used in the years for which the statute is open. 0446-0000

12. If [redacted] failed to make the required election on the Form 990 under section 266 but includes the interest, taxes and carrying charges in the basis of the applicable asset, and computes depreciation on the increased basis, what basis should be used in subsequent years. Does the answer depend on whether the statute is still open for the year of original election. 0266-0000

13. Does the inclusion of carrying costs in the basis of an asset without the proper election under section 266 result in a method of accounting from which the taxpayer would be entitled to change. 0446-0000; 0266-0000

14. What would be the correct treatment of disallowed basis due to the failure to make a proper election under section 266 when the original placed in service year of the asset is closed or open. 0446-0000; 0266-0000; 0481-0000

15. What would be the adjusted basis of a disposed asset for purposes of determining gain or loss if the depreciable basis used by [redacted] included interest, taxes, etc. without a proper section 266 election. 0481-0000

16. Does the claiming of depreciation on Form 990 establish a method of accounting for depreciation for all subsequent years as to the life and method of a particular asset, even if the entity subsequently becomes taxable. 0466-0000

17. Would the answer to any of the above responses change if the Form 990 were based on misleading or knowingly false information, and the entity would have been taxable had it filed accurate returns.

18. If a safe harbor lease is disqualified by an event in a year after the initial year of the lease, what is the year of recapture. Is the statute held open for purposes of recapture going back to the original year of the lease. 0168-0000

CONCLUSIONS

1. For purposes of this litigation, taxpayers should be considered to have met the 10% at risk requirements of the safe-harbor leasing provisions.

2. We believe that the identification of assets by undivided percentage interests is sufficient for the safe harbor provisions, however, this may require that some method be devised for allocating disallowance of basis if the total available basis amount falls below $[redacted].

3. The [redacted] lease properties are not transition property under section 208 of TEFRA.

4. The financing guaranteed by the REA can not be considered "subsidised energy financing" within the meaning of section 48.

5. The issuance of Industrial Development bonds does require the one-half reduction of the energy credit.

6. Only the property financed by the bonds should be subject to the one-half reduction in the energy credit.

7. A Form 990 is a return, and therefore will represent the election of a method of accounting, taxable period, depreciation lives and methods, section 266 election, and any other election under the Code.

8. Elections made on a Form 990 can only be made after securing consent from the Commissioner.

9. [redacted] would be not required to file an amended return even if in some year after filing the Form 990 it determined that it should have filed a Form 1120.

10. If the original Form 990 were filed on time and in good faith, there would be no penalty for failing to amend the filing.

11. A proper election on a Form 990 will be effective for subsequent years, regardless of whether the statute has expired for the year of election. The taxpayer may also be bound by an improper election, although the Commissioner can subsequently place the taxpayer on a proper method. A change in method without approval need not be recognized, whether the statute for the year of change is open or closed.

12. If [redacted] failed to make a proper election under section 266, but put the carrying costs in basis, basis would be reduced for any open years and through a section 481 adjustment, for closed years as well.

13. An improper election under section 266 is still considered an election of method from which the taxpayer may not change without consent.

14. As stated in 12, above, basis may be adjusted through a section 481 adjustment.

15. Basis on disposition of an asset subject to an improper section 266 election is the basis after the section 481 adjustment.

16. Claiming of depreciation on a Form 990 is an election, both as to asset life and depreciation method.

17. A fraudulent return would be subject to the penalties for fraud.

18. The regulations under the safe harbor lease provisions state that a disqualifying event in a year after the initial year of the lease will be treated as a sale of the leased asset by the lessor to the lessee, triggering section 47 and section 1245 recapture in the year of disqualification. A lease void from its inception will be treated as void for all years for which it was in effect which can still be reached under the statute.

FACTS

[redacted] owned an undivided interest in Plant [redacted]. Construction on Plant [redacted] was begun in [redacted] by [redacted], but was discontinued for lack of funds. Between [redacted] and [redacted] [redacted] generated the funds to continue construction by selling undivided interests in the plant -- [redacted]% to [redacted], [redacted]% to City of [redacted], and [redacted]% to [redacted]. Construction of the plant was complete in [redacted], and, as we concluded in our technical advice memorandum of May 11, 1988, the plant was placed in service on the synchronization date -- [redacted].

[redacted] subsequently entered into [redacted] safe harbor leases the subject of which was its [redacted]% undivided interest in the plant. The safe harbor leases with [redacted] and [redacted], which have also petitioned the Tax Court, began on [redacted]. The safe harbor lease with [redacted] began [redacted]. A [redacted] lease, with [redacted], involved portions of an integrated transmission system, and began on [redacted]. The safe harbor lease agreements were approved by the Rural Electric Administration (REA), and the proceeds from the leases were used to reduce [redacted]'s outstanding government guaranteed loans. The leases involving the [redacted]% undivided interest in Plant [redacted] are substantially the same. They identify the subject assets as section 38 property in a given amount -- identified by the amount of applicable tax credits. [redacted]'s undivided interest in the common facilities between [redacted] and [redacted] are part of the safe harbor transaction, even though [redacted]'s interest in the common facilities is subject to reduction by the completion and sale of [redacted], to which a [redacted]% interest in the common facilities will be attached.

The leases to [redacted], [redacted] and [redacted] also provide that in the event of disqualification of the safe harbor leases [redacted] will indemnify the safe harbor lessors in the approximate amount of $[redacted], which is approximately what [redacted] received from the lessors for entering into the leases. It is also approximately the amount of the asserted deficiency because of disqualification of the leases.

LEGAL ANALYSIS

1. At Risk Requirements

The minimum at risk requirements of the safe harbor provisions are found at Temp. Treas. Reg. § 5(c).168(f)(8)-4. This regulation provides that the lease characterization will not apply unless the lessor has, at all times covered by the lease, a minimum at risk investment equal to 10% of the adjusted basis of the leased property. At risk amounts included only consideration paid and recourse indebtedness incurred by the lessor. The lessor must have sufficient net worth to satisfy its liability for such indebtedness. You have asked whether the existence of an indemnification agreement, which would allow the entire lease transaction to be unravelled, would prevent a lessor from meeting the 10% at risk requirement.

The agreement between [redacted] and [redacted] provides for an initial payment equal to [redacted]% of [redacted]s cost basis in the subject property. The remaining installment obligation is nonrecourse. The [redacted]% payment was due on the closing date of the agreement. You have not suggested any reason for us to suppose that this amount was not bona fide, and was not in fact paid. The lease also contained a provision by which the lessor would be indemnified to some extent from a failure of the lease in a later year. We understand this indemnification agreement to operate so that after [redacted] years the indemnification payment would be less than the amount received by the lessee under the lease. Therefore, if the disqualifying event took place in year [redacted] or later, it would not necessarily reimburse the lessor for the full amount of original payment.

We suspect, as do the ISP Coordinators from Cleveland, who discussed this issue with all of us at the October 12, 1988 meeting, that these indemnification agreements are not uncommon. We would hesitate to conclude that they should be the undoing of their subject leases. The safe harbor lessors are, as far as we can judge, clearly on the hook for more than 10% of the basis of the property subject to the lease. There is no implication that this aspect of the agreement is fraudulent. We are aware of one case that would support an argument that where the entire series of transactions culminating in a safe harbor lease is a sham, the lease form may be disregarded even though on paper it complies with the requirements under section 168(f)(8). Greene v. Commissioner, 88 T.C. 376 (1987). We believe the situation here is more akin to an arms-length contract which contains a liquidated damages provision. Any contracting party is subject to damages if he misrepresents the facts at the inception of the agreement or subsequently fails to keep his bargain. While we appreciate the points you raise, we are not prepared in this case to assert that a provision which merely enunciates what the damages will be runs afoul of the 10% at risk requirements.

2. Identification of Assets

The agreement between [redacted] and [redacted] identifies the property subject to the lease as a [redacted]% interest in [redacted]'s undivided [redacted]% interest in the new section 38 property in Plant [redacted], and in [redacted]% of [redacted]'s [redacted]% interest in the new section 38 property in the common facilities. [redacted] claimed a basis in its interest of approximately $[redacted]. [redacted] of this amount was committed as new section 38 property subject to safe harbor leases. The parties agree that they intended to include only qualified section 38 property in the facilities covered by the leases. Any particular asset claimed as section 38 property by [redacted] and disallowed by the Service was to be deducted from [redacted]'s remaining $[redacted] in basis. There is a possibility, however, particularly given the failure to make a proper section 266 election, as discussed below, that substantially more than $[redacted] in assets will be disallowed. The question then becomes, how will these disallowances be borne among the lessors, and how do they effect the identification of assets in the leases.

As a general matter, we do not believe that anything prevents a taxpayer from identifying property subject to a transaction in this general manner. [redacted] owns a [redacted]% undivided share of all the assets in the plant, and they have conveyed this share in portions to the lessors. Moreover, if there were only one lessor instead of several, there would be no issue over which party owns what -- [redacted] would simply have conveyed all the section 38 property, or a percentage portion of it, to a single taxpayer.

The regulations, Temp. Treas. Reg. § 5c.168(f)(8)-2(a)(3)(ii)(C) provides that the return to be filed informing the Commissioner of the safe harbor election must contain "a description of each property with respect to which the election is made." That requirement is contained in a list with a number of other items that must be included on the return included the depreciation method and life, the unadjusted basis of the property, and certain of the lease terms. Nothing in the regulations would indication that a description of the asset sufficient to allow selection of a depreciation life or method would be insufficient for purposes of the safe harbor provisions. We are not inclined to take a position that the identification is insufficient for an effective election (note that the identification with which the regulations are concerned is that made on the informational return, and not that contained in the lease, although there is probably little practical difference in this case) under the regulations. The argument that the identification might be insufficient to transfer legal title (which may or may not be the case) should not be controlling, because the purpose of the safe harbor provisions is to recognize as a sale and lease a transaction that could not otherwise be so regarded.

Assuming that the assets subject to the lease have been sufficiently identified, we must determine how disqualifications of assets will be borne if the total available basis falls below $[redacted]. We believe that each taxpayer would bear its pro rata share of the disallowed assets, according to its percentage interest.

3. Transitional Rules

The agreement reached with [redacted] was dated [redacted]. The property subject to this agreement was placed in service in [redacted] of [redacted], thus the agreement would be subject to the modifications to the safe harbor provisions contained in section 208 of TEFRA, P.L. 97-248, unless it falls within one of the exceptions. The Conference Agreement, reprinted in Prentice-Hall Federal Taxes, vol. 3 at 15,704, provides that property will not be subject to the modifications if after December 30, 1980 and before July 2, 1982, a contract to construct the property was entered into by the lessee. Construction is defined in the Conference report, for purposes of the transitional rules, to have commenced when physical work on construction commences. Physical work is defined as including clearing and grading.

It is not disputed that contracts were entered into for clearing and grading on the properties subject to the [redacted] lease before July 2, 1982. Given the definition of construction, we interpret the rules to say that a contract for clearing and grading entered into before July 2, 1982 will qualify property for the exception to the transitional rules. Therefore we do not believe that the property subject to the [redacted] lease is transition period property.

4. Subsidized Energy Financing

5. Reduction in Energy Tax Credit

6. Property to Which Reduction Applies

The amendments to section 48(l)(11) made by the Crude Oil Windfall Profit Tax Act of 1980, which reduces the energy credit for property financed with subsidized energy financing, do not apply to [redacted] and the common facilities of Plant [redacted]. The amendments apply to property on which construction was completed after December 31, 1982, or which was acquired by the taxpayer after that date. Section 223(c)(2), P.L. 96-223 (1980). The construction of [redacted] and the common facilities was completed prior to December 31, 1982. The exception for "expanded energy credit property" also does not apply. See H.R. Conf. Rep. No. 3919, 96th Cong., 2d Sess. 137 (1980), 1980-3 C.B. 245, 197.

The applicable section for property placed in service between April 3, 1980 and January 1, 1983, is section 48(l)(11), which read as follows:

> Special Rule For Property Financed by Industrial Development Bonds.-In the case of property which is financed in whole or in part by the proceeds of an industrial development bond (within the meaning of section 103(b)(2)) the interest on which is exempt from tax under section 103, the energy percentage shall be one-half of the energy percentage determined under section 46(a)(2)(C). (emphasis added)

The [redacted] issued by [redacted] qualify as industrial development bonds (IDBs) under section 103(b)(2) and the interest on the bonds was exempt from taxation. See section 103(b)(4)(E). Therefore, whoever is entitled to the energy credits on Units [redacted] and the common facilities ([redacted] if the safe harbor leases are invalid or [redacted], [redacted] and [redacted] if the leases are valid) is only entitled to one-half of the energy percentage determined under 46(a)(2)(C) on the property actually financed by the bonds.

It should be noted that section 48(l)(11) does not require that the property be wholely financed by IDBs. (Here the property was only partially financed by the bonds.) However, the issuance of the IDBs only effects the energy credit available on property actually financed by the bonds.

Treas. Reg. { 46-3(a) states that "the qualified investment [for determining the investment credit]...is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property ...." (emphasis added) Thus, the basis of each piece of property must be determined separately. In a similar vein, it must be determined which pieces of property were financed, in whole or in part, by the bonds because only the basis of those pieces of property were effected by the bonds.

Support for this interpretation is found in the Conference Report to the Crude Oil Windfall Profit Tax Act of 1980. In describing the application of section 48(l(11) before the amendments made by the Act, the Report states: "...when energy property is installed in conjunction with other property that is allowed to be financed by industrial development bonds because such other property is described in section 103(b)(4), the energy property is not considered to be financed in whole or in part by industrial development bonds." H.R. Conf. Rep. No. 3919, 96th Cong., 2d Sess. 137 (1980), 1980-3 C.B. 245, 297.Thus, the IDBs would only effect the energy credit claimed on the pollution control facilities at Plant [redacted].

However, the burden is on the taxpayer to show which pieces of property were, in fact, financed by the bonds. If the funds from the bonds were put into a pool to pay a variety of costs, including the costs related to energy property, but no specific determinations can be made as to whether funds from the IDBs paid expenses related to the energy property, then all such energy property would be subject to the restrictions in section 48(l)(11).

Furthermore, there is nothing in section 48(l)(11) that requires the energy property be financed by IDBs at the time the property was placed in service. In the instant case, if it is determined that the property was placed in service in [redacted] (the synchronization date), the bonds would have been issued in a later year ([redacted]). In such a case [redacted] would have to increase its tax liability for [redacted] by one-half the energy credit that would have been properly claimed in [redacted].

If it is determined that the property was placed in service on the commercialization date ([redacted]), and the safe harbor lease were otherwise valid, [redacted], [redacted] and [redacted] would be entitled to the energy credit. However, their tax years ended shortly after the date the property was first used under the leases but before the issuance of the bonds. Thus, [redacted], [redacted] and [redacted] should have properly claimed the energy credit in the year the property was first used under the leases (deemed the date the property was placed in service) and then have included in their income in the subsequent year, when the bonds were issued, one-half the amount of credit previously claimed.

Section 47, recapture of investment credit, does not technically apply here because the energy property was not disposed of, nor did it cease to be section 38 property within the meaning of section 47(a). However, a recomputation is necessary because otherwise the intent of Congress -- to limit the investment credit on property financed with IDBs -- would be thwarted. <u>See</u> H.R. Cong. Rep. No. 3919, 96th Cong., 2d Sess. 137 (1980), 1980-3 C.B. 245, 297.

Section 48(l)(11) should be applied in the same way the tax benefit rule would apply. The issuance of the IDBs was, in effect, a recovery of part of the basis of the energy property which produced the same type of double tax benefit that is present in a typical tax benefit rule case. See Dobson v. Commissioner, 320 U.S. 489 (1943); Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983). In fact, section 48(l)(11) is, in effect, a codification of the tax benefit rule because it disallows this double tax benefit.

The classic example of the application of the tax benefit rule is where a creditor takes a bad debt deduction in year one and then recovers the debt in year two. Without the tax benefit rule, the creditor would receive the benefit of the deduction and the benefit of repayment. The tax benefit rule requires that the creditor include in income the amount of the recovery. Dobson, 320 U.S. 489 (1943). In this case, without section 48(l)(11) [redacted] (or the lessors) receives a benefit in year one when the benefit is taken, and in year two when the property is refinanced with IDBs. If section 48(l)(11) is applied, [redacted] (or the lessors) must include in income one-half of the energy credit claimed in the previous year.

Section 111 (recovery of tax benefit items) applies to credits, except the investment credit and foreign credit, for years after 1983. Congress excluded the investment credit from section 111 because the investment credit has its own codification of the tax benefit rule in section 47. Segal v. Commissioner, 89 T.C. 816, 841; H.R. Conf. Rep. No. 4170, 98th Cong., 2d Sess. 1, 1011 (1984), 1984-3 C.B. vol. 2 1, 265. It should be argued that section 48(l)(11) is equivalent to section 47 and the tax benefit rule.

The Tax Court has stated that the tax benefit rule does not apply to the investment credit before 1984. Segal 89 T.C. at 843 fn. 36 (1987). However, this statement should be of little consequence because in the instant case there is a specific Code section that requires the reduction of the energy credit.

Finally, it is of no consequence that [redacted] issued the bonds and that if the safe harbor leases are valid [redacted], [redacted] and [redacted] would be entitled to the energy credit because in such case the basis upon which the credit is calculated still includes the portion of the cost of the property that is being refinanced by the bonds. [redacted], [redacted] and [redacted] are using a basis for determining the energy credit based on [redacted]'s cost basis for the same property, and thus, the bonds' impact on the basis being used is the same no matter who gets the credit.

7. Elections on Form 990

Tax exempt and taxable entities are subject to recordkeeping and filing requirements under Treas. Reg. § 1.6001-1. The regulations require any person subject to tax or required to file a return to maintain books and records sufficient to verify the information shown on the required return. Exempt organizations are required to maintain the documentation necessary to demonstrate their exempt status, and to maintain these records according to a method of accounting accurate enough to establish their status. Section 446 requires that any method used by the taxpayer clearly reflect income. This requirement is no less applicable to tax exempt entities, who, after all, establish their status through the method of accounting they employ. See Rev. Rul. 67-173, 1967-1 C.B. 101, in which two tax exempt entities became taxable. The Rev. Rul. concludes that neither taxpayer is a new taxpayer for purposes of Treas. Reg. § 1.441-1(b)(3), because both were in existence from an earlier time, and were required to file a return for that earlier period. See also [redacted] G.C.M. 38400, I-313-78 (June 4, 1980) (copy attached).1/

A Form 990 is a tax return, and must be filed based on accurate financial data in order to permit audit and verification. Therefore the methods of accounting for material items used to prepare the 990 will be considered to have been elected by the taxpayer; such methods include the taxable period, depreciation, capitalization elections, or any other material item. Treas. Reg. § 1.446-1(e)(1) states that a taxpayer filing his first return may adopt any permissible method of accounting in computing taxable income for the year covered by the return. Section 446(e) and Treas. Reg. § 1.446-1(e)(2) require that once such adoption has been made, no change in method may take place without the consent of the Commissioner, regardless of whether the new method is permissible under the Code. Change in method includes a change in treatment of any material item, that is, an item which involves the proper time for the inclusion of income or the taking of a deduction.

1/ As you are aware, if you wish to provide copies of National Office documents such as G.C.M.s to anyone outside the Office of Chief Counsel, the redacted, published versions should be used. OMs should not be circulated in any form.

8. Change to Taxable Status

Given that the Form 990 is a return, then the method employed on the first 990 represents the election of an accounting method, as the treatment of any particular item represents the election of a method with regard to that item. The proscription in section 446(e) against changing methods without the Commissioner's consent would apply to a taxpayer who went from filing a form 990 to filing an 1120 -- no new method may be elected without obtaining the consent of the Commissioner. Logic, as well as the Code, dictates this result -- it is the taxpayer's method that results in the determination of taxable or tax exempt status in the first place. [redacted]'s use of netting in some years and not in others is a particularly apt illustration of this. Whether or not expenses were netted against the income obtained in the sale of capacity to [redacted] could make the difference between taxable and tax exempt status for [redacted]. Clearly, then, this treatment is material, and a consistent method must be employed, and then may not be changed without the consent of the Commissioner. By being transformed into a taxable entity, [redacted] has not become a new taxpayer, a change in legal status of the same entity is all that took place. Grogan v. United States, 475 F.2d 15 (5th Cir. 1973); Travis v. Commissioner, 47 T.C. 502 (1967), aff'd, 406 F.2d 987 (6th Cir. 1969).

9. Filing of an 1120X

In Koch v. Alexander, 561 F.2d 1115, 1117 (4th Cir. 1977) the court stated as follows:

> There is simply no statutory provision authorizing the filing of amended tax returns; and while the IRS has, as a matter of internal administration, recognized and accepted such returns for limited purposes, their treatment has not been elevated beyond a matter of internal agency discretion.

See also Civil Fraud Penalty - What is a Return, O.M. 19525, I-273-81 (January 5, 1982) (copy attached). Given that there is no statutory provision authorizing an amended return, neither is there any requirement that one be filed. Therefore we conclude that [redacted] would not have been legally obligated to file an amended return even if it later discovered that an 1120 should have been filed in place of a Form 990.

10. Penalties for Failure to Amend Return

I.R.C. § 6653(a) provides that if any part of an underpayment of tax is due to negligence or intentional disregard of rules and regulations (but without intent to defraud), there shall be added to the tax an amount equal to five percent of the underpayment. Treas. Reg. § 1.6011-1(b) provides, in part, that each taxpayer should carefully prepare his return and set forth fully and clearly the information required to be included therein.

According to Leroy Jewelry Company v. Commissioner, 36 T.C. 443 (1961), a taxpayer has a duty to file an accurate return. The return need not be perfectly accurate or complete if it is filed in substantial compliance with the requirements for a return. McDonald v. United States, 315 F.2d 769 (6th Cir. 1963). In order for a document to constitute a tax return, it must contain sufficient data from which the Service can compute and assess the taxpayer's liability with respect to a particular tax. Durovic v. Commissioner v. United States, 487 F.2d 36 (7th Cir. 1973).

Failure to file an amended return will not subject a taxpayer to any penalties by reason of that failure. However, if a taxpayer does file an amended return and it is accepted by the Service, the taxpayer will be able to avoid the negligence penalty in I.R.C. § 6653(a). This is because the taxpayer will have made a reasonable attempt to comply with the provisions of the Code.

This analysis assumes that the Form 990 in question was filed in good faith. If the return was fraudulently filed, a subsequently filed amended return will not absolve the taxpayer from the penalties described in I.R.C. § 6653. See Hirschman v. Commissioner, 12 T.C. 1223 (1949); [redacted], G.C.M. 39248, I-314-82 (May 19, 1983), p. 5.

11. Which Method Should Be Applied

You inquired which method should be applied if [redacted] elected one method on its original Form 990 and another in a subsequent year, both of which years are closed. The proper method to be applied would depend on the particular facts of the case. The Commissioner has the option of accepting the change and making appropriate section 481 adjustments, or not accepting the change and computing income under the method applied by the taxpayer in previous years. Falk v. Commissioner, 37 T.C. 1062 (1962), acq., 1965-2 C.B. 4, aff'd, 332 F.2d 922 (5th Cir. 1964). If the original method were proper, that is, resulted in a clear reflection of income, and had been properly elected, it would be applied to the remaining open years. If the original method were improper or improperly elected, the change would not be honored, but the Service on audit might select a third method that would be correct under the requirements of section 446.

A taxpayer that has elected a method, albeit an improper one, may still not change methods without the consent of the Commissioner. Consistent but erroneous treatment of an item will constitute an election. Freuhauf Corporation v. Commissioner, 356 F.2d 975 (6th Cir. 1965), cert. denied, 385 U.S. 822 (1966). Such adoption may not subsequently be altered without consent. American Can Co. v. Commissioner, 317 F.2d 604 (2d Cir. 1963). Therefore, if the original method was used so consistently as to have been adopted, then the change in method cannot be effective if made without consent. In reviewing the treatment, however, the Commissioner will apply whichever method is correct under the Code, and not be ruled by one or the other of the taxpayer's elections. If the original method was erroneous, and the taxpayer changed to a correct method, the Commissioner might choose to apply the second method, but because of its correctness, not because it was elected by the taxpayer.

12-16. Election Under Section 266

Section 266 allows a taxpayer to elect capitalization of taxes and carrying charges of certain property, rather than currently deducting these charges. If the election is made, of course, the expenses may not be deducted. The regulations under section 266 provide that the election may be made on a project by project basis, but expenditures of the same type on the same project must all be treated consistently. An election with respect to unimproved real property will be valid only for the year in which it is made. An election with respect to property undergoing improvement, or with respect to personal property will be effective until the construction of the improvement is completed or the personal property is installed or placed in service, whichever is later. Treas. Reg. § 1.266-1(c)(2).

The section 266 election requires an affirmative statement that the election is being made, in the first year of the election. Treas. Reg. § 1.266-1(c)(3). The Service has been rather strict about the requirement that the election to capitalize be explicit, by statement attached to the return filed for the year in which the election is first effective. Elections allowed by legislative grace must be made in the manner and at the time prescribed. Southeastern Mail Transport, Inc. et al. v. Commissioner, T.C. Memo. 1987-104; Green v. Commissioner, T.C. Memo. 1964-113. Once an election has been made it cannot be revoked. Est. of Stamos v. Commissioner, 55 T.C. 468 (1970).

It is also our position that an improper election, which, for purposes of section 266 means the consistent use of capitalization treatment without an express election to do so, is not revokable without consent. Rev. Rul. 75-56, 1975-1 C.B. 98, clarified by Rev. Rul. 77-236, 1977-2 C.B. 84. In Rev. Rul. 75-56 the taxpayer capitalized carrying costs for ten years without properly electing to do so. By the time the taxpayer chose to alter its method, the time for amending the first return on which capitalization had been elected had expired. The Service held that by letting the statute run on that first return, the taxpayer had elected the method. On the other hand, in Rev. Rul. 70-539, 1970-2 C.B. 70, the taxpayer was allowed to go back and file amended returns for the last three years, in which it had capitalized carrying charges without a proper election. That ruling found that by amending the three years before the statute closed, the taxpayer was in effect electing a method of accounting -- to deduct such costs currently.

There is one recognized exception to the requirement that the section 266 election be made by an affirmative statement that 266 capitalization is being used. The case of Kentucky Utilities Co. v. Glenn, 394 F.2d 631 (6th Cir. 1968) held that where the taxpayer attached a schedule to the return filed in the original year of election which clearly indicated that certain carrying charges were being capitalized without actually stating that 266 treatment was elected would still be sufficient to make the election. In Rev. Rul. 76-325, 1976-2 C.B. 88, this form of making the election was stated to be proper.

At our October 12, 1988 meeting, we discussed the fact that the taxpayer filed several Forms 990 capitalizing carrying costs without making a proper section 266 election. However, in the last year in which they filed a Form 990 they attached an express election to use section 266 capitalization. They then continued to capitalize carrying costs for some of their initial taxable years, but then sought to return to a method of taking current deductions for these costs. Had the taxpayer not made an express election to capitalize, they might have been able to argue that they made an election in compliance with Rev. Rul. 76-325, and therefore should retain the capitalized costs in basis. Their subsequent express election undercuts this argument, however. The election made on the final Form 990, however, was a valid, binding election, and could not be revoked in a later year without consent merely because the entity became taxable.

Given that the election was properly made in [redacted], and not for any year before, the question becomes how to treat the basis in the preceding years, including those years for which the statute is now closed. In the case of [redacted], [redacted] will be the first year of election. This leaves the question of how to dispose of previous years in which carrying charges were capitalized, and subsequent years, in which they were deducted.

The adjustments to taxpayer's basis for years before [redacted] and the disallowance of deductions for years after represent two separate changes in the taxpayer's method of accounting, to which section 481 is applicable. Therefore an adjustment to basis may be made for any years in which basis was improperly increased, regardless of whether the statute of limitations has run on those years. An offsetting deduction would be allowable for amounts that would have been deductible in those years had the taxpayer employed the proper method. If all the years in which [redacted] capitalized carrying costs on Forms 990 are still open, the adjustment can be made in each year. If some of those years are now closed, the basis used in the first open year can be corrected through a section 481 adjustment, with appropriate allowance of deductions, so that no item is included twice, or excluded. See Cameron Iron Works, Inc. v. United States, 45 AFTR2d 80-1597 (Ct. of Cl. 1980); Adolph Coors Co. v. Commissioner, 519 F.2d 1280 (10th Cir. 1975).

The years after the adoption of capitalization treatment on the [redacted] return are still open, so the deductions taken in those years can be disallowed, and the taxpayer required to continue to capitalize carrying costs until permission of the Commissioner is obtained to change methods. Thus, two method changes are being required. The first is for years before [redacted], in which capitalization was not properly elected and therefore will not be allowed. The second is for taxable years after [redacted] in which deductions were taken after a proper section 266 election was in effect.

We would expect the taxpayer to argue that the changes to capitalization treatment are merely corrections of error and not changes due to a change in accounting method, thus rendering section 481 inapplicable. We would argue that the capitalization election is a method of accounting within the meaning of section 446, and that the change is a change in method, not a correction. Dearborn Gage Company v. Commissioner, 48 T.C. 190 (1967).

16. *Method of Depreciation*

For all the foregoing reasons, claiming of depreciation on a Form 990 does constitute a binding election of method and asset life for all subsequent years. Section 168, as in effect for property placed in service between 1980 and 1986, provided that an election was to be made on the tax return for the taxable year concerned (the year in which the depreciated asset was placed in service). An election made under section 168 could only be revoked with the consent of the Commissioner. Internal Revenue Code of 1954 § 168(f)(4)(C). The regulations make it clear that no consent will be granted under section 168(f)(4) to change from a method not described in section 168 to certain methods that are. Prop. Treas. Reg. § 1.168-5(e). For some alternative depreciation methods, the rules of section 168 itself apply to prescribe the method of requesting a change. A request to change methods prescribed in section 168 must be made in accordance with that section; the section 168 requirements cannot be bypassed by making a request under section 446(e). Prop. Treas. Reg. § 1.168(e)(6).

Where a depreciation election is not specifically limited in section 168 as irrevocable, or revocable under that section, the method and asset life fall within the normal coverage of section 446. Obviously, under section 446, the taxpayer may not change methods without the consent of the Commissioner, once the method has been elected on the first return. Thus, whether the method elected by [redacted] is one expressly designated irrevocable, or revocable only with consent under section 168 or falls within the general rule of section 446, the filing of the first Form 990 constituted an election from which the taxpayer may not change without consent. Rev. Rul. 74-154, 1974-1 C.B. 59.

17. Knowingly Misleading Returns

If a taxpayer submits a Form 990 knowing that it is a taxable entity, the taxpayer will become liable for a number of civil as well as criminal penalties.

The civil fraud penalty under section 6653(b) is one of the principal weapons the Service has for use against taxpayers who deliberately file false returns. Willfully signing a fraudulent return will subject the signer to the penalties of perjury under section 7206(1). The signer and any other responsible person may also be subject to the 100 percent penalty for will failure to evade or defeat the tax under section 6672.

A willful attempt to evade a tax will subject the taxpayer to criminal penalties under section 7201. Such a taxpayer may also be subject to the criminal penalties for fraudulent statements under section 7204 and 7207. In addition, there may be penalties for substantial understatement of liability under section 6661 and failure to include correct information under section 6723(b).

The next question to resolve is whether a fraudulently filed Form 990 is a return. Section 6501(g)(2) indicates that a Form

990 filed in good faith is a return even though the taxpayer is thereafter held to be a taxable organization.

O.M. 19525 addresses the question of whether a fraudulent return is a return. The O.M. concludes that a fraudulent return is a return if the taxpayer intended the return to be a specific statement of his items of income and deductions. See Florsheim Bros. Co. v. United States, 280 U.S. 453, 462 (1929).

It should be noted that there are minimum essential criteria for a document to constitute a return. Those criteria are discussed in O.M. 19525. In essence, the return must be signed and must contain a statement of gross income and deductions from which the Service may calculate net income. We are not aware of any lack of these criteria in the returns at issue.

18. Disqualifying Events

If an event occurs in a year after the inception of a safe harbor lease that would disqualify the lease from safe harbor treatment, the safe harbor regulations dictate the result. Temp. Reg. § 5c.168(f)(8)-8 describes which events can lead to the loss of section 168(f)(8) protection, and what the consequences of such a loss will be. In the year in which the disqualifying event takes place the lease will cease to be characterized as a lease. Depreciation and tax credits will be recaptured as determined under sections 47 and 1245. If the lessee would be considered the owner of the property without regard to the safe harbor provisions, then the property will be considered to have been sold by the lessor to the lessee in the year of disqualification. Depreciation deductions taken by the lessor will be reflected in the basis of the property in the hands of the lessee, and section 1245 recapture will apply on disposition by the lessee as if it had been the owner for the entire life of the asset. Internal Revenue Code of 1954 § 1245(a)(6). Recapture can be divided between the lessor and lessee by agreement.

You also asked that we offer an opinion on the proper analysis of the sale of capacity by [redacted] to [redacted] for purposes of the member/non-member income calculations. The sale of capacity was intended by the parties to be a sale of an intangible right, in the nature of an option agreement. Therefore relatively few costs should be associated with the sale of capacity. The generating costs of electricity would be properly associated with the sale of electricity, which was the subject of a separate provision in the agreement between [redacted] and [redacted]. Any calculation of member versus non-member income should be made accordingly.

We hope this will be of assistance to you. If you have any questions with regard to the matters discussed herein, please contact Ms. Clare E. Butterfield at (FTS)566-3442.

MARLENE GROSS

By: Gerald M Horan
GERALD M. HORAN
Senior Technician Reviewer
Branch 1 (Tax Litigation)

Attachments (3):
G.C.M. 39248
G.C.M. 38400
O.M. 19525